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September 5, 2003

Loan Guaranty Bulletin No. 26-03-14

SUBJECT: HYBRID ADJUSTABLE RATE MORTGAGES

1. PURPOSE: The Veterans Benefits Act of 2002 authorizes VA to carry out a demonstration project to guarantee Hybrid Adjustable Rate Mortgages (Hybrid ARMs) during Fiscal Years 2004 and 2005. This circular provides information about implementing the project.
2. EFFECTIVE DATE: PLEASE NOTE that VA is authorized to guarantee Hybrid ARM loans that close **on or after October 1, 2003**. Lenders should not close VA Hybrid ARM loans **prior** to that date. This circular is being released prior to that date so lenders can make any necessary modifications to their systems and/or procedures.
3. INTEREST RATES: Hybrid ARMs will specify an initial rate of interest that is fixed for a period of at least 3 years. After that the rate can be adjusted annually. Annual adjustments are limited to 1 percent, and the maximum increase in the interest rate over the life of the loan is capped at 5 percent.
 - a. Interest Rate Index. The index for VA Hybrid ARMs will be the same as that used by HUD which is the weekly average yield on U.S. Treasury securities adjusted to a constant maturity of 1 year. (This information is found in the Federal Reserve Bulletin and made available by the Federal Reserve Board in Statistical Release H.15.)
 - b. Margins. VA will not dictate what margin lenders must use when processing Hybrid ARM loans. It's expected that market forces will determine what the appropriate margin should be.
 - c. Frequency of Interest Rate Changes. Interest rate adjustments must occur on an annual basis, except that the first adjustment may occur no sooner than 36 months from the date of the borrower's first mortgage payment.
4. PRE-LOAN DISCLOSURE. The lender is required to explain the nature of the obligation to the borrower in writing at the time of loan application. The borrower must certify that he or she fully understands the obligation. A copy of the signed certification should be retained as part of the loan origination package. The lender disclosure must include:

- The fact that the mortgage interest rate may change, and an explanation of how changes correspond to changes in the interest rate index;
- Identification of the interest rate index, its source of publication and availability;
- The frequency (i.e. annually) with which interest rate levels and monthly payments will be adjusted, and the length of the interval (36 months) that will precede the initial adjustment;
- A hypothetical monthly payment schedule that displays the maximum potential increases in monthly payments to the borrower over the first 5 years of the mortgage, subject to the provisions of the mortgage instrument.

5. UNDERWRITING: Hybrid ARMs will be underwritten at the note rate. Because the interest rate on VA's Hybrid ARM loan will remain fixed for at least 3 years, there is no need to underwrite at a higher rate in anticipation of a possible rate increase within 12 months, which would be possible under the traditional 1 year ARM.

6. TEMPORARY BUYDOWNS. Lenders may not use temporary buydowns in connection with Hybrid ARMs.

7. LOAN ASSUMPTIONS. For VA Hybrid ARM loans that are later assumed,

the lender/holder must provide the transferee with the same disclosure noted in paragraph 4.

8. VA FORM 26-0286, VA LOAN SUMMARY SHEET. This form has been revised to accommodate the new Hybrid ARM loan. It can be downloaded at the form link on the VA Loan Guaranty Service web page: <http://www.vba.va.gov/pubs/homeloanforms.htm>

/Signed/

ROBERT JOHNSON
Loan Guaranty Officer